

ORIGINAL NEW APPLICATION



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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

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DOCKETED

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COMMISSIONERS

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E-04204A-06-0720

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IN THE MATTER OF THE APPLICATION
OF UNS ELECTRIC, INC. FOR AN
ACCOUNTING ORDER.

) DOCKET NO. E-04204A-06-_____

) APPLICATION FOR AN
) ACCOUNTING ORDER

) (Expedited Consideration Requested)

UNS Electric, Inc. ("UNS Electric"), through undersigned counsel, hereby respectfully requests that the Arizona Corporation Commission ("Commission") issue an Order authorizing UNS Electric to establish a deferral accounting method to reflect mark-to-market accounting in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments*, as amended. In support hereof, UNS Electric states as follows:

I. INTRODUCTION.

UNS Electric is an Arizona public service corporation that provides electric transmission and distribution services to approximately 91,000 retail customers in Mohave and Santa Cruz Counties.

UNS Electric is a party to a full requirements power supply agreement with Pinnacle West Capital Corporation (the "PWCC Agreement"). The PWCC Agreement expires May 31, 2008. UNS Electric will have to acquire power to replace that which is currently provided in the PWCC agreement.

The Financial Accounting Standards Board ("FASB") establishes standards of financial accounting and reporting which govern the preparation of financial reports. The FASB is officially recognized as authoritative by the Securities and Exchange Commission and the American Institute

1 of Certified Public Accountants. UNS Electric applies the standards set by the FASB for the
2 preparation of its financial statements.

3 SFAS No. 133 was issued by the FASB in June 1998 and was subsequently amended by
4 SFAS No. 138 (June 2000) and SFAS No. 149 (June 2003). The Federal Energy Regulatory
5 Commission ("FERC") incorporated SFAS No. 133, as amended, into its Uniform System of
6 Accounts with the issuance of Order No. 627 on October 10, 2002. SFAS No. 133 requires all
7 derivatives to be reported on a company's balance sheet at their fair market value. A derivative is a
8 financial instrument or other contract that meets certain criteria outlined in SFAS No. 133. SFAS
9 No. 133 also requires that changes in the fair market value (the difference between the contract and
10 the market price) of derivatives are to be recorded in a company's earnings or other comprehensive
11 income at the end of each reporting period. Changes in the fair market value of derivatives are also
12 reported as unrealized gains or losses even though there is no associated cash flow (this is known as
13 "mark-to-market"). When the derivative is actually "settled" an expense is recognized for the actual
14 price and the resultant net unrealized gain or loss previously recorded on the company's financial
15 statements is reversed.

16 Certain power agreements are not subject to the accounting requirements of SFAS No. 133
17 and, therefore, are not required to be "marked-to-market". For example, agreements entered into with
18 "physical" counterparties which generally require delivery of power are not subject to SFAS No.
19 133. A "physical" counterparty is an entity that owns or has contractual rights to capacity and the
20 ability to deliver the underlying service or commodity, such as the ability to direct or transport power
21 to the electric transmission system of the pertinent operating control area. (For example, Arizona
22 Public Service Company would be considered a physical counterparty to UNS Electric.)

23 The PWCC Agreement is not a derivative, and, therefore is not subject to the "mark-to-
24 market" requirements of SFAS No. 133. However, UNS Electric may enter into agreements to
25 secure replacement for the PWCC Agreement with "financial" counterparties. A financial
26 counterparty is an entity that cannot demonstrate ownership of or rights to capacity and the capability
27 to deliver the underlying service or commodity, such as no ownership of the power contracted to be

1 delivered to the transmission system of the control area. (For example, Morgan Stanley Capital
2 Group, Inc. does not own generated or transmitted power nor the physical facilities associated
3 therewith.) A power supply agreement with a financial counterparty would be a derivative under
4 SFAS No. 133, and therefore subject to the "marked-to-market" requirements of SFAS No. 133.

5 Changes in the fair market value of derivatives under SFAS No. 133 are recorded in one of
6 two ways. Unrealized gains and losses are either recorded in the income statement or, if certain
7 specific criteria are met, they are accounted for as cash flow hedges with the changes in fair market
8 value recorded in Other Comprehensive Income ("OCI"), a component of equity. Such unrealized
9 gains and losses are recognized as income each reporting period after a derivative agreement is
10 signed, even though the power may not be taken for a considerable period of time.

11 The set price for power in purchase supply agreements can vary substantially from market
12 prices at any point in time. For example, UNS Electric has an agreement for 10MW of on-peak, firm
13 energy to be delivered to its service territory beginning in June 2008 through December 2013 priced
14 at \$71.00 per MWh. At July 31, 2006, (as a result of record heat across the country and high oil
15 prices) market prices for power had increased substantially from the agreement amount of \$71.00.
16 The change in the fair market value resulted in UNS Electric recording an unrealized gain in OCI of
17 approximately \$2.5 million in one month. Market prices for power then decreased in August, which
18 resulted in UNS Electric recording an approximate \$1.3 million unrealized loss. However, the price
19 for power under the agreement remained the same.

20 It is likely that power prices will continue to vary, and additional unrealized losses and/or
21 gains of the same or greater amounts may be recorded on the financial statements of UNS Electric.
22 Further, to mitigate potential price risk associated with the power supply agreements, UNS Electric
23 may also enter into hedging agreements which, under the derivative accounting rules, would have to
24 be regularly marked-to-market. These agreements could create the potential for significant volatility
25 in UNS Electric's financial statements.¹

26
27 ¹ In order to put the potential impact of SFAS No. 133 into perspective, the 10MW agreement
referenced by way of example represents approximately two percent of UNS Electric's 2006 peak demand. If

1 Applying the provisions of SFAS No.133 can cause significant volatility in UNS Electric's
2 income statement and stockholders' equity, and could significantly and negatively impact its ability
3 to comply with debt covenants. Non-compliance with debt covenants would increase the cost of
4 capital for UNS Electric. UNS Electric's financing arrangements, ability to attract capital and
5 possible credit enhancements, which may be required under future power purchase arrangements,
6 could also be adversely affected. All of these adverse effects would result in an increase in the cost
7 of providing service to customers.

8 UNS Electric could selectively enter only into fixed price contracts with no minimum
9 purchase requirements with "physical" counterparties, in order to avoid having to apply SFAS No.
10 133 to its power purchase contracts. Unfortunately, this course of action could increase the cost of
11 power by limiting the types of contracts and counterparties from whom UNS Electric can buy power,
12 thereby eliminating potentially advantageous economic alternatives.

13 UNS Electric believes that a more appropriate solution for avoiding the negative
14 consequences of SFAS No. 133 is to request from this Commission an order authorizing the utility to
15 defer mark-to-market accounting related to unrealized gains and losses consistent with the
16 requirements of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. This
17 solution would provide the same outcome as only purchasing power from "physical" counterparties.
18 This is the means by which utilities and regulators have resolved this problem in other jurisdictions.
19 A chart depicting the instances in which an order has been issued authorizing the deferral of mark-to-
20 market accounting is set forth in Exhibit B and attached hereto.

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22
23 UNS Electric were to fulfill 20 percent of its load requirement under similar power purchase agreements, the
24 unrealized gains and losses recorded would have been ten times greater, namely, \$25 million and \$10.3
25 million, respectively. Such changes are significant considering UNS Electric's total Stockholder's Equity is
26 approximately \$62 million as of June 30, 2006. A chart illustrating the potential impacts of SFAS No. 133 to
27 UNS Electric's income statement and stockholder's equity is attached hereto as Exhibit A and by this
reference incorporated herein.

1 **II. REQUEST FOR DEFERRAL ORDER.**

2 UNS Electric hereby requests that the Commission issue an order authorizing the utility to
3 record the changes in fair market value (unrealized gains or losses) of energy resource acquisition
4 agreements and any related hedging agreements, defined as derivatives under SFAS No. 133, as
5 deferred assets or liabilities in FERC Account No. 186, "Miscellaneous Deferred Debits", and FERC
6 No. 253, "Other Deferred Credits".

7 An amount equal and opposite to these non-cash accounting entries, which reflects the fair
8 market value of the derivative assets or liabilities, would be recorded in FERC Account No. 175,
9 "Derivative Instrument Assets", or FERC Account No. 244, "Derivative Instrument Liabilities".
10 This is consistent with present accounting practices provided by the FERC Uniform System of
11 Accounts, General Instruction No. 24B. When the obligations related to resource acquisition
12 agreements are settled, any unrealized gain or loss previously recorded would be reversed in
13 accordance with SFAS No. 133 and the offsetting asset or liability would also be reversed. The
14 actual price paid would be recorded just as it is today, through UNS Electric's Purchased Power and
15 Fuel Adjustment Clause ("PPFAC"), and subsequently through earnings. This is consistent with
16 normal accounting for energy resource purchases not considered derivatives under SFAS No. 133.

17 This requested deferral accounting method will have no effect on the accounting currently
18 used for the costs of fuel and purchased power, nor would there be any impact on the existing
19 PPFAC mechanism. The only costs currently permitted for recovery through UNS Electric's PPFAC
20 are the actual cost of purchased power, the cost of bulk transmission service provided by the Western
21 Area Power Administration to deliver that power, and the cost of fuel used by the utility's emergency
22 generation back-up facilities in Santa Cruz County. Accordingly, none of the temporary mark-to-
23 market accounting entries resulting from the proposed accounting methodology would appear in the
24 PPFAC bank tracking account. The only costs charged to the PPFAC account would be the actual
25 power supply costs as such power is received and the actual contract settlements paid. Additionally,
26 UNS Electric will neither seek rate base treatment for the requested SFAS No. 133 deferral accounts,
27

1 nor cost recovery of any amounts temporarily recorded therein, as such amounts represent non-cash
2 items.

3 This proposed accounting treatment would result in equal and opposite entries in the balance
4 sheet, eliminating the potential earnings and equity volatility caused by SFAS No. 133. Any adverse
5 effect on UNS Electric's reported earnings, ability to comply with debt covenants, financing
6 arrangements, ability to attract capital or credit enhancements required under future power purchase
7 agreements would be eliminated.

8 UNS Electric believes it is in the public interest for the Commission to authorize the utility to
9 use deferral accounting related to the application of SFAS No. 133 because it will eliminate the
10 likelihood that the volatility in earnings and stockholder's equity will result in non-compliance with
11 debt covenants. As previously mentioned, such non-compliance with debt covenants would (i)
12 adversely limit UNS Electric's access to capital markets and the availability of financing alternatives;
13 (ii) increase UNS Electric's cost of capital which would increase the cost of providing service to its
14 customers; (iii) eliminate adverse impacts on possible credit enhancements that could be required in
15 order to procure sufficient power to meet UNS Electric's jurisdictional load requirements; and (iv)
16 allow UNS Electric to procure power from the most economical resources available and provide
17 service to customers at the lowest price possible.

18 UNS Electric respectfully requests **expedited consideration and approval** of the proposed
19 accounting treatment such that it may be incorporated into the Company's accounting and reporting
20 system in sufficient time to be reflected in the financial statements to be issued for December 31,
21 2006.

22 WHEREFORE, for all of the foregoing reasons, UNS Electric requests that the Commission
23 issue an Order:

- 24 1) Granting approval of this Application;
 - 25 2) Ordering that the Order be deemed effective December 31, 2006; and
 - 26 3) Granting any such further relief as the Commission deems necessary.
- 27

1 RESPECTFULLY SUBMITTED this 13th day of November 2006.

2 UNS ELECTRIC, INC.

3
4 By 

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9 and

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15 Attorneys for UniSource Energy Services

16 Original and thirteen copies of the foregoing
17 filed this 13th day of November, 2006, with:

18 Docket Control
19 ARIZONA CORPORATION COMMISSION
20 1200 West Washington Street
21 Phoenix, Arizona 85007

22 Copy of the foregoing hand-delivered
23 this 13th day of November, 2006, to:

24 Chairman Jeff Hatch-Miller
25 Arizona Corporation Commission
26 1200 West Washington Street
27 Phoenix, Arizona 85007

Commissioner William A. Mundell
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Mike Gleason
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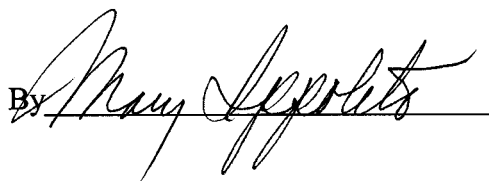
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25
26
27
By 

EXHIBIT

"A"

The following tables illustrate the potential impacts that mark-to-market accounting could have on UNS Electric's stockholder's equity. The first scenario shows the impact on 2005 stockholder's equity had UNS Electric recorded an after tax unrealized loss of \$1.5 million at December 31, 2005. This loss is equivalent to the unrealized loss on UNS Electric's 10MW contract recorded in July 2006. The following scenarios increase the impacts to illustrate the potential volatility that could result had the experienced change in market value been applied to contracts providing 100MWs and 400MWs. Within the next 18 months, UNS Electric could be contracting for 100-400MWs.

Scenario 1 – December 2005 Stockholder's Equity adjusted to reflect an unrealized loss in fair value of \$2.5 million (\$1.5 million on a net income, after tax basis)

(\$ in thousands)	Accumulated Earnings	Total Stockholder's Equity
Balances at December 31, 2004	\$6,287	\$44,904
Net Income for the Year Ended 2005	4,994	4,994
Unrealized Loss	(1,500)	(1,500)
Balance at December 31, 2005	\$9,781	\$48,398

Scenario 2 – December 2005 Stockholder's Equity adjusted to reflect an unrealized loss in fair value of \$25 Million (\$15 million on a net income, after tax basis). The unrealized loss is three times UNS Electric's annual earnings.

(\$ in thousands)	Accumulated Earnings (Retained Deficit)	Total Stockholder's Equity
Balances at December 31, 2004	\$ 6,287	\$44,904
Net Income for the Year Ended 2005	4,994	4,994
Unrealized Loss	(15,000)	(15,000)
Balance at December 31, 2005	\$ (3,707)	\$34,898

Scenario 3 – December 2005 Stockholder's Equity adjusted to reflect an unrealized loss in fair value of \$100 Million (\$60 million on a net income, after tax basis). The unrealized loss exceeds total stockholder's equity.

(\$ in thousands)	Accumulated Earnings (Retained Deficit)	Total Stockholder's Equity (Deficiency)
Balances at December 31, 2004	\$ 6,287	\$44,904
Net Income for the Year Ended 2005	4,994	4,994
Unrealized Loss	(60,000)	(60,000)
Balance at December 31, 2005	\$(48,719)	\$ (10,102)

The following tables further illustrate the potential impacts that mark-to-market accounting could have on UNS Electric's stockholder's equity. The scenario shows the impact on 2005 stockholder's equity had UNS Electric recorded unrealized gains rather than losses. Regardless of the unrealized change, loss or gain, UNE Electric wants to eliminate the income statement and balance sheet volatility caused by changing power prices.

Scenario 1 – December 2005 Stockholder's Equity adjusted to reflect an unrealized gain in fair value of \$2.5 million (\$1.5 million on a net income, after tax basis)

(\$ in thousands)	Accumulated Earnings	Total Stockholder's Equity
Balances at December 31, 2004	\$6,287	\$44,904
Net Income for the Year Ended 2005	4,994	4,994
Unrealized Gain	1,500	1,500
Balance at December 31, 2005	\$12,781	\$51,398

Scenario 2 – December 2005 Stockholder's Equity adjusted to reflect an unrealized loss in fair value of \$25 Million (\$15 million on a net income, after tax basis)

(\$ in thousands)	Accumulated Earnings	Total Stockholder's Equity
Balances at December 31, 2004	\$ 6,287	\$44,904
Net Income for the Year Ended 2005	4,994	4,994
Unrealized Gain	15,000	15,000
Balance at December 31, 2005	\$26,293	\$64,898

Scenario 3 – December 2005 Stockholder's Equity adjusted to reflect an unrealized loss in fair value of \$100 Million (\$60 million on a net income, after tax basis)

(\$ in thousands)	Accumulated Earnings	Total Stockholder's Equity
Balances at December 31, 2004	\$ 6,287	\$ 44,904
Net Income for the Year Ended 2005	4,994	4,994
Unrealized Gain	60,000	60,000
Balance at December 31, 2005	\$71,281	\$109,898

EXHIBIT

"B"

EXHIBIT B

Examples of Public Utility Commissions that Have Addressed Regulatory Accounting for SFAS No. 133

State Commission	Regulated Company	Order / Decision	FERC Accounts Used to Record Changes in Fair Market Value (Unrealized Gains (Losses))
California	PacifiCorp	01-08-049	186, Miscellaneous Deferred Debits; 253, Other Deferred Credits
	Sierra Pacific Power Company	02-10-0554	174, Miscellaneous Current and Accrued Assets; 242, Miscellaneous Current and Accrued Liabilities
Idaho	Idaho Power Company	28661	Regulatory Assets or Liability not specified
	Avista Corporation	28648	Regulatory Assets or Liability not specified
	PacifiCorp	28735	182.3, Other Regulatory Assets 254, Other Regulatory Liabilities
Utah	Utah Power & Light Company	01-035-12	182.3, Other Regulatory Assets 254, Other Regulatory Liabilities
Oregon	Cascade Natural Gas	04-212	186, Miscellaneous Deferred Debits; 253, Other Deferred Credits
	PacifiCorp	01-540	182.3, Other Regulatory Assets 254, Other Regulatory Liabilities
Nevada	Sierra Pacific Power Company	01-11030	182.3, Other Regulatory Assets 253.3, Other Deferred Credits